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Suggested Guidelines for CPA Participation in the American Bankers Association Preferred Group Bonding Plan

**Prepared by the Committee on Banking
of the American Institute of Certified Public Accountants**

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Table of Contents

	<i>Page</i>
Introduction	1
Summary of the ABA Plan	2
Qualification Questionnaire	3
Engagement Letters	4
Examination Procedures	4
Other Illustrations	4
CPA Participation Under the Plan	5
Types of Engagements	5
Follow-Up Engagements	10
Summary of Procedures to Be Followed by CPAs Providing Services to Banks Participating Under the ABA Preferred Group Bonding Plan	10
Exhibits	
A—CPA Firm’s Qualification Form	15
B—Illustrative Engagement Letter—Balance Sheet Ex- amination and Report on System of Internal Ac- counting Control	17

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Suggested Guidelines for CPA Participation in the American Bankers Association Preferred Group Bonding Plan

Introduction

The American Bankers Association (ABA) has developed a preferred group bonding plan (plan) to help bankers and insurers establish and maintain a bankers blanket bond insurance market. This market is intended to provide bankers with adequate fidelity and surety coverage and to provide insurers with a reasonable return on risk investment. The plan contains guidelines and procedures designed to reduce the risk of losses to banks arising from the dishonest acts of directors, officers, and employees.

The AICPA Committee on Banking (committee) believes that guidance is necessary for CPAs wishing to participate in the plan. Specifically, the committee believes assistance is necessary to enable CPAs to provide banks with the required services that meet both the objectives of the plan and the standards of the accounting profession.

The committee concurs with the need for sound internal controls for all banks, as expressed in the plan.¹ The committee also believes that, depending on the individual circumstances, a bank may want to avail itself of a more extensive examination which

1. The term *internal controls* as used in the plan coincides with the scope of internal accounting controls as defined in section 320.28–.29 of the AICPA's Statement on Auditing Standards (SAS) no. 1, *Codification of Auditing Standards and Procedures*.

would provide other benefits to the bank and at the same time fulfill the objectives of the plan.

This document is intended to (1) familiarize CPAs with the plan, (2) describe how to obtain approval from the ABA as a “bank examination firm,” and (3) provide guidance for establishing the scope of special examinations and issuing reports thereon.²

Summary of the ABA Plan

The plan was developed by a task force made up of representatives from insurance companies, banks, and bank regulatory agencies. Details relating to the plan are contained in a document published by the ABA entitled *ABA Preferred Group Bonding Plan*. It should be thoroughly studied by firms intending to provide services to banks participating in the plan.³ This section summarizes the pertinent parts of the plan as set forth in the ABA publication. The following section provides guidance to CPAs wishing to participate under the plan.

The plan is intended primarily for banks with total assets of \$300 million or less. It specifies certain steps which must be taken before a bank can be accepted into the preferred group program. A bank must first complete a “memorandum of understanding” in which the bank’s directors agree to provide for periodic outside independent special examinations and to adopt any reasonable recommendations as to internal controls resulting therefrom. The ABA would then supply to the bank an “approved list of bank examination firms.” Such examination firms would not necessarily be limited to CPA firms. The bank would select an examining firm from this list and would be responsible for paying the firm’s fee. The examining firm would review the bank’s present system of internal control. If deficiencies are found in the system, the examining firm’s report must contain specific recommendations for corrective action. A follow-up examination would be required to determine whether suggested corrections had been implemented by the bank. The bank would subject itself to annual follow-up special

2. The term *special examination* is used to denote an examination in accordance with the requirements of the plan as opposed to an examination of the financial statements in accordance with generally accepted auditing standards.

3. A copy of the plan may be obtained from the Insurance and Protection Division, American Bankers Association, 1120 Connecticut Avenue, N.W., Washington, D.C. 20036.

examinations by contracting separately with an examination firm on the approved list.

The plan requires that the results of the special examination and examining firm's report be addressed to the bank's board of directors. A copy of the report is to be submitted by the examiner directly to the ABA Examiner Review Committee. The plan also requires that if information is to be separately submitted to the ABA by the bank, the examining firm should read this information for consistency with the information contained in the examiner's report. A copy of the additional information separately submitted by the bank to the ABA will also be supplied to the examining firm by the bank. Insurers would then decide whether they would underwrite the bank's bond, and at what premium. The premium and loss experience of participating banks would be monitored by the Surety Association of America and the ABA to evaluate the impact of the plan on premium costs.

Qualification Questionnaire

The plan specifies the requirements for examining firms to qualify to perform the special examinations. Included among the requirements is the completion and submission of a qualification questionnaire by prospective firms. An illustrative qualification questionnaire is presented in the plan document as a guide to non-CPAs for presenting the firm's credentials. In addition, the ABA has indicated that either the ABA questionnaire or the illustrative AICPA qualification form presented in Exhibit A of these guidelines will be acceptable for CPAs. To be considered for qualification as an examining firm by the ABA, the examining firm must also guarantee that lead, "on-the-job" examiners will meet certain criteria as set forth on page 11 of the plan document. In addition, the prospective examining firm may be required to: demonstrate its staffing capabilities for bank examinations; represent that it will commit the required experienced staff to examination engagements; include in the examination reports details of assigned staff personnel, including names, educational and business experience, and areas of responsibility; and represent that the firm will withdraw from any engagement in which the firm does not consider itself independent.

The plan also stipulates that the ABA Examiner Review Committee reserves the right to review the examiner's workpapers at ABA expense.

Engagement Letters

The plan includes a sample engagement letter for contracts between banks and examining firms. The suggested contract provides that the examining firm would perform within a specified period “a detailed evaluation of the bank’s internal control system in accordance with the policies and procedures set forth in the ‘Review Program’ and ‘Internal Control Reporting System of the ABA Preferred Group Bonding Plan.’ ” The firm would issue a report on such evaluation, and perform a follow-up review to determine whether recommendations for improvement had been implemented by the bank. The examining firm would agree to provide copies of all reports to the ABA.

Examination Procedures

Examination procedures suggested by the ABA plan are contained in the “Review Program” and “Internal Control Reporting System” sections of the plan. The review program lists suggested examination procedures, such as counts of certain assets, and a sample outline of a “Report of Review.” The “Internal Control Reporting System” contains a sample internal control questionnaire and suggestions for an examining firm assisting a bank in establishing an internal control system. The plan states that the review program and the internal control questionnaire are intended to be used as guidelines and are designed to be flexible at the discretion of the examiner in charge. The examiner in charge is responsible for determining the scope of the special examination and the extent of testing based on professional judgment, in compliance with “established professional standards.”

Other Illustrations

In addition to the examination procedures, the plan also indicates suggested bank documents a firm might examine in conducting its review. It contains a sample letter from the firm to the bank listing documents and records which the firm may require for its examination; a sample letter authorizing other auditors to discuss their audits with the examining firm; and sample work sheets for accumulation of data relating to employees, officers, and directors. It also includes a sample agreement to be signed by the bank in which the bank agrees to give the examining firm access to all needed

records and states its understanding of limitations on the intended purpose of the examination.

CPA Participation Under the Plan

The previous section summarizes the objectives and requirements of the plan, including the responsibilities of the ABA, participating banks, and examining firms. The committee believes that additional guidance is necessary for CPAs who wish to participate in the plan as examining firms.⁴ Certain aspects of the plan need clarification, and compliance with other parts requires modification to allow CPAs to conform to professional standards. Also, some of the suggestions which follow go beyond the minimum requirements specified in the plan.

The primary focus of a special examination conducted under the plan is the review of a bank's system of internal accounting control. At a minimum, the plan requires a limited, or defined scope, special purpose examination.

A significant number of banks have directors' examinations or issue audited financial statements. Whenever appropriate, consideration should be given to modifying or expanding the scope of the special engagement contemplated under the plan to fulfill multiple examination requirements so that a bank may avoid duplicative audit procedures and unnecessary expense.

Additionally, the procedures in the plan provide limited guidance for compliance testing of internal accounting control for loans. This is an area in which significant fidelity bond losses have occurred in the past. Consequently, CPAs should consider the necessity of expanding tests of loans beyond those outlined in the plan.

Types of Engagements

The type of engagement best suited to a given bank client is that most responsive to the bank's requirements. Generally, engagements which could be performed under the plan are of three types:

- Examination of financial statements that are intended to present

4. The recommendations set forth in this document are based on present professional standards of the AICPA. The AICPA Auditing Standards Board has recently issued an exposure draft of a proposed statement on auditing standards on reporting on internal accounting control. Any subsequent pronouncement by the AICPA on this subject may require modification of the recommendations herein.

financial position, results of operations, and changes in financial position.

- Examination of balance sheet only.
- Special examination.

In many cases, a special examination as outlined below will meet the requirements of the plan. However, some insurance companies participating in the plan may require an auditor's standard report on a bank's financial statements, or balance sheet only, in addition to the basic requirements of the plan.

The reports that could be included under the various types of engagements are—

1. Examination of financial statements.
 - a. Report on audit of financial statements (standard report) or standard report with supplemental description of certain audit procedures.
 - b. Report on a special study of internal accounting control disclosing material weaknesses in internal accounting control and exceptions to criteria set forth in the "Questionnaire on Internal Control" in section 4 of the *ABA Preferred Group Bonding Plan* (see current AICPA statements on auditing standards).⁵
 - c. Management letter which recites exceptions noted and recommends procedures which may be instituted to improve internal accounting control.⁶
2. Examination of balance sheet only (see paragraph 13 of SAS no. 2, *Reports on Audited Financial Statements*).

5. The auditor's evaluation of accounting control with reference to each significant class of transactions and related assets should be a conclusion as to whether the prescribed procedures and compliance therewith are satisfactory for his purpose. The procedures and compliance should be considered satisfactory if the auditor's review and tests disclose no condition he believes to be a material weakness for his purpose. In this context, a material weakness means a condition in which the auditor believes the prescribed procedures or the degree of compliance with them does not provide reasonable assurance that errors or irregularities in amounts that would be material in the financial statements being audited would be prevented or detected within a timely period by employees in the normal course of performing their assigned functions. These criteria may be broader than those that may be appropriate for evaluating weaknesses in accounting control for management or other purposes (see current AICPA statements on auditing standards).

6. The information provided in the management letter may be incorporated in the discussion of material weaknesses in internal accounting control in the report on a special study of internal accounting controls (see current AICPA statements on auditing standards).

- a. Report on audit of balance sheet or balance sheet report with supplemental description of certain audit procedures.
 - b. Report on a special study of internal accounting control (see 1 b above).
 - c. Management letter (see 1 c above).
3. Special examination.
 - a. Report based on an engagement in which the scope of the engagement is limited to applying, to one or more specified elements, accounts, or items of financial statement(s), agreed upon procedures, as specified in the review program of the plan, that are not sufficient to enable the CPA to express an opinion on the specified elements, accounts, or items. In this type of engagement, the CPA should be guided by paragraphs 15-17 of SAS no. 14, *Special Reports*.
 - b. Report on a special study of internal accounting control (see 1 b above). However, in no event should such a report be issued in a document that includes unaudited financial statements (see current AICPA statements on auditing standards).
 - c. Management letter (see 1 c above).

The plan document contains an illustrative work program to guide examiners in conducting examinations and a sample outline of report of review suggesting the type of information and forms of schedules to be contained in the report. The committee believes that the data submitted by CPAs need not contain all the information specified in the plan. Including all the specified information in a CPA's report would require extensive audit procedures which could be unnecessarily expensive for the bank. The plan allows for certain information to be submitted by bank management under the signature of two officers. The committee believes this can be done without jeopardizing the intent of the plan. The specified information would be submitted as two separate packages under the plan as follows:

- Information to be submitted by an examining firm.
- Information to be submitted by bank management.

CPAs should read the information submitted by bank management under the plan and not covered by their reports for consistency with the information contained in their reports. When audited financial statements are involved, CPAs should consult SAS no. 8, *Other Information in Documents Containing Audited Financial Statements*.

The committee believes the information to be provided by CPAs should be limited to the following:

1. Report which includes the following information on scope—
 - General recitation of the scope of the special examination.
 - General areas covered in the program for the special examination.
 - Summary of “direct confirmation” results.
 - Key persons interviewed (this information could also be included in a separate schedule).

(Note: If the engagement includes an examination of financial statements, the CPA should consult current AICPA statements on auditing standards.)

2. Financial statements (if examined and reported on).⁷
3. Schedule of director and officer loans (information should conform to the requirements of article 9 of Regulation S-X of the Securities and Exchange Commission).⁸
4. Report on a special study of the system of internal accounting control including the criteria set forth in the *ABA Preferred Group Bonding Plan*. CPAs should disclose in their reports any material weaknesses in the system that come to their attention even when not covered in the plan. The reports should also indicate those matters which are exceptions to the “Questionnaire on Internal Control” that came to their attention during an examination.
5. Schedule E—recommendations for improving internal accounting controls (this report is commonly referred to as a “management letter”). The suggested letter contained in the plan manual contains reference to timing and priority of implementation of recommendations; however, the committee believes that any reference to timing or priority of implementation should be a separate communication by bank management outside of a CPA’s report. Similarly, any agreement by bank management to implement any of the recommendations

7. If the scope of the engagement is limited to applying, to one or more specified elements, accounts, or items of financial statement(s), agreed upon procedures, as specified in the review program of the plan, that are not sufficient to enable the CPA to express an opinion on the specified elements, accounts or items, the CPA should refer to paragraphs 15–17 of SAS no. 14, *Special Reports*.

8. The CPA should describe the scope of the examination of the schedule and the degree of responsibility assumed (see current AICPA statements on auditing standards).

contained in the management letter should be separate from a CPA's report. The information contained in the management letter could be incorporated in the discussion of material weaknesses and exceptions in the report on a special study of internal accounting controls.

Following are the items which normally would be submitted by bank management. CPAs should assure themselves that information transmitted under separate cover is clearly designated by the bank as not covered by the CPAs' reports.

1. Required financial statement information if not reported on by a CPA.
2. Bonding loss history for the last six years (bank should secure listing from present or prior bonding companies).
3. Corrective actions relating to blanket bond losses of the last six years.
4. Reason for bond cancellations or failure to renew (bank should secure letter from present bonding company).
5. Organization chart.
6. Accounting methods or policies (normally should be included in accounting policies note to financial statements).
7. Financial analyses.
8. Loan policies.
9. Scope of internal audit.
10. Resumes of five highest paid officers.
11. Pending defensive litigation (ordinarily such information would be prepared by bank's counsel; if a CPA is rendering an opinion on the bank's financial statements, or the balance sheet only, significant items should be disclosed as required by FASB Statement no. 5, *Accounting for Contingencies*).
12. Detail of general operational procedures, internal accounting controls, and physical security.
13. Schedule B—bank personnel, twenty highest paid individuals.
14. Schedule C—board of directors information.
15. Schedule D—stock ownership information.
16. Schedule E (see item 5 under information to be provided by CPAs)—any reference to timing or priority of implementation of recommendations by the examining firm and any agreement to implement any of the recommendations should be submitted separately by the bank and apart from a CPA's report.

Follow-up Engagements

The plan provides that an examining firm would, within six to twelve months following the initial engagement, conduct a follow-up examination to determine the extent to which control and operational improvements had been effected. Even though the intent of the bank to engage the examining firm may have been stated in the original engagement letter, any follow-up work should be treated as a separate engagement, and the scope and terms should be established at the time of such work.

Summary of Procedures to Be Followed by CPAs Providing Services to Banks Participating Under the ABA Preferred Group Bonding Plan

The requirements of the *ABA Preferred Group Bonding Plan* should be reviewed carefully by those wishing to participate as examining firms. The ABA has indicated that the suggested forms, procedures, and reports are illustrative and can be modified as necessary in the circumstances. The following are recommendations of the committee for CPAs wishing to participate in the preferred group bonding program:

1. *Prequalification of examiners.* Generally the qualification of one's firm as an "approved examiner" will be the first step in the process of participation in the *ABA Preferred Group Bonding Plan*. This procedure is initiated by completing a "qualification questionnaire." Exhibit A is a recommended qualification form to be used by CPAs in submitting the necessary information to the ABA.
2. *Engagement letter.* Once selected by a bank as its examiner, the CPA firm should prepare an initial engagement letter which clearly sets forth the scope of the examination, the degree of responsibility assumed, the type of report(s) to be presented, and the fee. Particularly in a special study of the system of internal accounting control, the period of time that the engagement and resulting reports will cover should be set forth in the letter. Exhibit B presents a suggested engagement letter that the committee feels meets the objectives of the plan. The sample letter is for an audit which includes a balance sheet examination and report on the system of internal accounting control.

As mentioned, the plan does not require an examination of financial statements. Depending on the specific circumstances, a firm and its bank client may agree to an engagement which would serve other requirements, such as a directors' examination, as well as fulfilling the objectives of the plan. The engagement letter should be modified as needed to indicate the scope of the engagement.

3. *Accountant's report.* An examining firm would provide its report as specified in the engagement letter and would meet with the bank's board or its audit committee to review findings and recommendations. The report on the bank's system of internal accounting control should be in conformity with current AICPA statements on auditing standards and should be addressed to the client bank or its board of directors.
4. *Report forwarded to ABA.* With the written consent of the bank, the examining firm should send a copy of its report to the American Bankers Association, Examiner Review Committee, 1120 Connecticut Avenue, N.W., Washington, D.C. 20036. The CPA's transmittal letter to the ABA should include appropriate restrictive language indicating the limited scope, purpose, and distribution of the report. If a CPA is aware that the bank is submitting unaudited financial statements or similar information to the ABA, the CPA should request that the financial statements and similar information be marked to indicate that it is not covered by the CPA's report. The CPA has no obligation to perform any procedures to corroborate the information provided by the bank under separate cover letter. However, the CPA should read the bank's information and consider whether such information, or the manner of its presentation, is materially consistent with information, or the manner of its presentation, appearing in the CPA's report.
5. *Follow-up engagement.* An examining firm should conduct a follow-up engagement to ascertain that recommended improvements, which had been discussed with and agreed to by the board, had been implemented by the bank. Such follow-up work should be conducted within a period of six to twelve months following the completion of the initial examination.

Exhibits

EXHIBIT A

(Note: The ABA may request such additional information as it deems necessary to satisfy itself as to a firm's qualifications.)

CPA Firm's Qualification Form

Name of Firm: _____

Address: _____

A. *Type of Practice*

State that your firm is in the practice of public accounting.

B. *Experience*

Describe your firm's experience in providing audits, directors' examinations, management services, tax, and other services in the banking industry. This could include the number and size of your present bank clients and any other information which you believe would be helpful to the ABA Examiner Review Committee.

C. *Independence*

Describe your firm's independence policies and any specific policies relative to bank engagements. Most likely, this would include rule 101 and related interpretations of the AICPA *Code of Professional Ethics' Rules of Conduct*, along with any particular independence policies of the firm pertaining to bank engagements.

D. *Standards of Professional Practice*

Describe the standards to which your firm must adhere in conducting engagements. This would include generally accepted auditing standards and other standards or policies of the firm.

E. *Continuing Professional Education*

Describe your specific continuing education program concerning individuals of your firm who work on bank engagements.

F. *Planning and Supervision*

Provide sufficient information to indicate that your firm has the staffing capability in the area of bank audits and examinations meeting the requirements set forth in the plan under "Selection Criteria—Entity to Perform Examinations" or indicate that your firm will commit to the engagement persons having the degree of technical training and proficiency required in the circumstances. Indicate your firm's policies and procedures for assigning personnel to engagements.

G. *Liability Insurance*

Indicate whether your firm carries liability insurance; if so, state the name of the carrier.

H. *Access to Workpapers*

State your firm's policies regarding ABA access to workpapers relating to engagements under the plan. (*Note:* Should the need arise for the ABA to review an examining firm's workpapers, all costs incurred by ABA reviewers will be paid for by the ABA. The examining firm would only be required to absorb the in-house costs necessary to assist in the review.)

Firm _____

Date _____

EXHIBIT B

Illustrative Engagement Letter— Balance Sheet Examination and Report on System of Internal Accounting Control

Board of Directors
(Name of Bank)
(Address)

Gentlemen:

This will confirm our understanding of the agreement made with you regarding the examination of the balance sheet of the (*name of bank*) as of (*date*) and the review of the bank's system of internal accounting control.

Our examination will be made in accordance with generally accepted auditing standards and, accordingly, will include tests of the accounting records and such other auditing procedures as we consider necessary to enable us to issue the appropriate auditor's report on the bank's balance sheet.*

An essential feature of our examination is the study and evaluation of the bank's system of internal accounting control to establish a basis for reliance thereon in determining the nature, timing, and extent of other auditing procedures that are necessary for expressing an opinion on the balance sheet and to assist us in planning and performing our examination of the balance sheet.

In connection with our study and evaluation of the system of internal accounting control, we will issue a report on the material weaknesses in internal accounting control that come to our attention and exceptions to the criteria set forth in the "Questionnaire on Internal Control" in section 4 of the *ABA Preferred Group Bonding Plan*. As required by the plan, our study will include tests of compliance with the system. The report will include suggestions for correction of the exceptions to the "Questionnaire on Internal Control" disclosed during our examination and other comments appropriate in the circumstances. Our examination will not necessarily disclose all exceptions in the system because it will be based on selective tests of accounting records and related data.

Because our examination will be based on selective tests of accounting records and related data, it will not necessarily disclose fraud, defalca-

* The report may express an unqualified, qualified, or adverse opinion or disclaimer of opinion.

tions or other irregularities, although any such matters coming to our attention will be reported to you immediately.

We understand that the report on the system of internal accounting control is to be used as part of your bank's participation in the *ABA Preferred Group Bonding Plan* and is to be made available to selected sureties. In accordance with your request, we also will submit a copy of our report to the ABA Examiner Review Committee.

Our fee for this work will be at our regular per diem rates plus travel and other direct costs. Based upon our estimates of the hours required for this engagement, we estimate that our fee will fall in the range of \$_____ to \$_____. In the event that the time required to complete the examination is less than our estimates, we would, of course, bill the lesser amount. If, on the other hand, we encounter a situation that was not foreseen in our estimates and which would subsequently increase the time required, we would discuss the matter with you before proceeding further. Should any follow-up work be required, as contemplated in the *ABA Preferred Group Bonding Plan*, we would negotiate this separately at the time such work is found to be warranted.

If this letter correctly expresses our understanding, please indicate your agreement to these arrangements by signing and returning the enclosed copy.

Very truly yours,

(Name of Firm)

Approved:

By _____

Date _____

Date _____

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